church. Admission to Organization B is open to all members of the community for a fee. Organization B advertises in publications of general distribution appealing to the elderly and maintains its name on non-denominational listings of available retirement homes. Therefore, Organization B offers its services for sale to the general public on more than an incidental basis. Organization B receives a cash contribution of $50,000 annually from the church. Fees received by Organization B from its residents total $100,000 annually. Organization B does not receive any government support or contributions from the general public. Total support is $150,000 ($100,000 + $50,000), and $100,000 of that total is from receipts from the performance of services (66⅔% of total support). Therefore, Organization B receives more than 50 percent of its support from receipts from the performance of services. Organization B is not internally supported and is not an integrated auxiliary.

*Example 3.* Organization C is a hospital that is described in sections 501(c)(3) and 509(a)(1). Organization C is affiliated (within the meaning of this paragraph (h)) with a church. Organization C is open to all persons in need of hospital care in the community, although most of Organization C's patients are members of the same denomination as the church with which Organization C is affiliated. Organization C maintains its name on hospital listings used by the general public, and participating doctors are allowed to admit all patients. Therefore, Organization C offers its services for sale to the general public on more than an incidental basis. Organization C annually receives $250,000 in support from the church, $1,000,000 in payments from patients and third party payors (including Medicare, Medicaid and other insurers) for patient care, $100,000 in contributions from the public, $100,000 in grants from the federal government (other than Medicare and Medicaid payments) and $50,000 in investment income. Total support is $1,500,000 ($250,000 + $1,000,000 + $100,000 + $100,000 + $50,000), and $1,200,000 ($1,000,000 + $100,000 + $100,000) of that total is support from receipts from the performance of services, government sources, and public contributions (80% of total support). Therefore, Organization C receives more than 50 percent of its support from receipts from the performance of services, government sources, and public contributions. Organization C is not internally supported and is not an integrated auxiliary.

* * * * *

Margaret Milner Richardson,

*Commissioner of Internal Revenue.*

Approved: November 27, 1995.

Leslie Samuels,

*Assistant Secretary of the Treasury.*

[FR Doc. 95–30839 Filed 12–19–95; 8:45 am]

BILLING CODE 4830–01–U

## 26 CFR Parts 1, 301 and 602

**[TD 8632]**

**RIN 1544–AM00**

## Section 482 Cost Sharing Regulations

**AGENCY:** Internal Revenue Service (IRS), Treasury.

**ACTION:** Final regulations.

**SUMMARY:** This document contains final regulations relating to qualified cost sharing arrangements under section 482 of the Internal Revenue Code. These regulations reflect changes to section 482 made by the Tax Reform Act of 1986, and provide guidance to revenue agents and taxpayers implementing the changes.

**DATES:** These regulations are effective January 1, 1996.

These regulations are applicable for taxable years beginning on or after January 1, 1996.

**FOR FURTHER INFORMATION CONTACT:** Lisa Sams of the Office of Associate Chief Counsel (International), IRS (202) 622–3840 (not a toll-free number).

**SUPPLEMENTARY INFORMATION:**

### Paperwork Reduction Act

The collections of information contained in these final regulations have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545–1364. Responses to these collections of information are required to determine whether an intangible development arrangement is a qualified cost sharing arrangement and who are the participants in such arrangement.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid control number.

The estimated average annual burden per recordkeeper is 8 hours. The estimated average annual burden per respondent is 0.5 hour.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be sent to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, T:FP, Washington, DC 20224, and to the Office of Management and Budget, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503.

Books and records relating to these collections of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

### Background

Section 482 was amended by the Tax Reform Act of 1986, Public Law 99–514, 100 Stat. 2085, 2561, et. seq. (1986–3 C.B. (Vol. 1) 1, 478). On January 30, 1992, a notice of proposed rulemaking concerning the section 482 amendment in the context of cost sharing was published in the Federal Register (INTL–0372–88, 57 FR 3571).

Written comments were received with respect to the notice of proposed rulemaking, and a public hearing was held on August 31, 1992. After consideration of all the comments, the proposed regulations under section 482 are adopted as revised by this Treasury decision, and the corresponding temporary regulations (which contain the cost sharing regulations as in effect since 1968) are removed.

### Explanation of Provisions

#### *Introduction*

The Tax Reform Act of 1986 (the Act) amended section 482 to require that consideration for intangible property transferred in a controlled transaction be commensurate with the income attributable to the intangible. The Conference Committee report to the Act indicated that in revising section 482, Congress did not intend to preclude the use of bona fide research and development cost sharing arrangements as an appropriate method of allocating income attributable to intangibles among related parties. The Conference Committee report stated, however, that in order for cost sharing arrangements to produce results consistent with the commensurate-with-income standard, (a) a cost sharer should be expected to bear its portion of all research and development costs, on unsuccessful as well as successful products, within an appropriate product area, and the costs of research and development at all relevant development stages should be shared, (b) the allocation of costs generally should be proportionate to profit as determined before deduction for research and development, and (c) to the extent that one party contributes funds toward research and development at a significantly earlier point in time than another (or is otherwise putting its funds at risk to a greater extent than the other) that party should receive an appropriate return on its investment. See H.R. Rep. 99–281, 99th Cong., 2d Sess. (1986) at II–638.

The Conference Committee report to the Act recommended that the IRS conduct a comprehensive study and consider whether the regulations under section 482 (issued in 1968) should be modified in any respect.

*The White Paper*

In response to the Conference Committee's directive, the IRS and the Treasury Department issued a study of intercompany pricing [Notice 88–123 (1988–2 C.B. 458)] on October 18, 1988 (the White Paper). The White Paper suggested that most bona fide cost sharing arrangements should have certain provisions. For example, the White Paper stated that most product areas covered by cost sharing arrangements should be within three-digit Standard Industrial Classification codes, that most participants should be assigned exclusive geographic rights in developed intangibles (and should predict benefits and divide costs accordingly) and that marketing intangibles should be excluded from bona fide cost sharing arrangements.

Comments on the White Paper indicated that, in practice, there was a great deal of variety in the terms of bona fide cost sharing arrangements, and that if the White Paper's suggestions were incorporated in regulations, the regulations would unduly restrict the availability of cost sharing.

*The 1992 Proposed Regulations*

The IRS issued proposed cost sharing regulations on January 30, 1992 (INTL–0372–88, 57 FR 3571). In general, the proposed regulations allowed more flexibility than anticipated by the White Paper, relying on anti-abuse tests rather than requiring standard cost sharing provisions.

The proposed regulations stated that in order to be qualified, a cost sharing arrangement had to meet the following five requirements: (1) the arrangement had to have two or more eligible participants, (2) the arrangement had to be recorded in writing contemporaneously with the formation of the cost sharing arrangement, (3) the eligible participants had to share the costs and risks of intangible development in return for a specified interest in any intangible produced, (4) the arrangement had to reflect a reasonable effort by each eligible participant to share costs and risks in proportion to anticipated benefits from using developed intangibles, and (5) the arrangement had to meet certain administrative requirements. The key requirements were that participants had to be eligible and that costs and risks had to be proportionate to benefits.

Under the proposed regulations, only a controlled taxpayer that would use developed intangibles in the active conduct of its trade or business was eligible to participate in a cost sharing arrangement. This requirement was considered necessary to ensure that controlled foreign entities were not established simply to participate in cost sharing arrangements without performing any other meaningful function, and to ensure that each participant's share of anticipated benefits was measurable.

The proposed regulations allowed costs to be divided based on any measurement that would reasonably predict cost sharing benefits (e.g., anticipated units of production or anticipated sales). However, the basis for measuring anticipated benefits and dividing costs was checked by a cost-to-operating-income ratio. The method for dividing costs was presumed to be unreasonable if a U.S. participant's ratio of shared costs to operating income attributable to developed intangibles was grossly disproportionate to the cost-to-operating-income ratio of the other participants.

If a U.S. participant's cost-to-operating-income ratio was not grossly disproportionate, a section 482 allocation could still be made under three circumstances: (a) if the cost-to-operating-income ratio was disproportionate (allocation of costs), (b) if the pool of costs shared was too broad or too narrow, so that the U.S. participant was paying for research that it would not use (allocation of costs), or (c) if the cost-to-operating-income ratio was substantially disproportionate, such that a transfer of an intangible could be deemed to have occurred (allocation of income).

Under the proposed regulations, the IRS could also make an allocation of income to reflect a buy-in or buy-out event, that is, a transfer of an intangible that could occur, for example, when a participant joined or left a cost sharing arrangement.

*Comments on the 1992 Proposed Regulations*

The 1992 proposed cost sharing regulations were generally well received. However, there were five areas of particular concern to commenters. The first was the mechanical use of cost-to-operating-income ratios as a standard for measuring the reasonableness of an effort to share costs in proportion to anticipated benefits. Commenters noted that operating income attributable to developed intangibles was difficult to measure, and that other bases for measuring benefits might produce more reliable results. Commenters also believed that the ratios might be overused, leading to adjustments to costs in every year, and to many deemed transfers of intangibles. In addition, commenters stated that the ratios did not provide any certainty that a cost sharing arrangement would not be disregarded, since a ''grossly disproportionate'' ratio was not numerically defined.

The second area of concern was the eligible participant requirement. Commenters argued that separate research entities (with no separate active trade or business) should be allowed to participate in cost sharing arrangements, as should marketing affiliates. Commenters also argued that transfers of intangibles to unrelated entities should not disqualify a participant, and that foreign-to-foreign transfers should not necessarily be monitored. Some comments also stated that controlled entities should be able to participate even if their cost sharing payments would be characterized differently for purposes of foreign law.

The third area of concern was the regulations' requirement that every participant be able to benefit from every intangible developed under a cost sharing arrangement. Commenters stated that the regulations should allow both single-product cost sharing arrangements and umbrella cost sharing arrangements (i.e., cost sharing arrangements under which a broad category of a controlled group's research and development would be covered).

The fourth area of concern was the buy-in and buy-out rules. There were some suggestions for clarifying and simplifying the rules. For example, comments urged that the regulations provide that one participant's abandonment of its rights would not necessarily confer benefits on the other participants, and that a new participant need not always make a buy-in payment when joining a cost sharing arrangement. Suggestions for simplifying the rules generally consisted of proposed safe harbors for valuing intangibles.

The final general area of concern was the administrative requirements. Several commenters suggested that annual adjustments to the method used to share costs should not be required. Commenters also suggested that taxpayers not be required to attach their cost sharing arrangements to their returns, and that the time period for producing records be increased.

In addition to these general areas of concern, commenters noted that there should be more guidance about when the IRS would deem a cost sharing

arrangement to exist. Commenters also argued that existing cost sharing arrangements should be grandfathered, or that there should be a longer transition period. Commenters suggested that financial accounting rules be used to calculate costs to be shared, and that the IRS address the impact of currency fluctuations on the cost-to-operating-income ratios. Finally, commenters asked that the regulations clarify that a cost sharing arrangement would not be deemed to create a partnership or a U.S. trade or business.

*The Final Regulations*

Without fundamentally altering the policies of the 1992 proposed regulations, the final regulations reflect numerous modifications in response to the comments described above. They also reflect the approach of the final section 482 regulations relating to transfers of tangible and intangible property.

Section 1.482–7(a)(1) defines a cost sharing arrangement as an agreement for sharing costs in proportion to reasonably anticipated benefits from the individual exploitation of interests in the intangibles that are developed. In order to claim the benefits of the safe harbor, a taxpayer must also satisfy certain formal requirements (enumerated in § 1.482–7(b)). The district director may apply the cost sharing rules to any arrangement that in substance constitutes a cost sharing arrangement, notwithstanding any failure to satisfy particular requirements of the safe harbor. It is further provided that a qualified cost sharing arrangement, or an arrangement treated in substance as such, will not be treated as a partnership. (A corresponding provision is added to § 301.7701–3 pertaining to the definition of a partnership.) Neither will a foreign participant be treated as engaged in a trade or business within the United States solely by virtue of its participation in such an arrangement.

Section 1.482–7(a)(2) restates the general rule of cost sharing in a manner intended to emphasize its limitation on allocations: no section 482 allocation will be made with respect to a qualified cost sharing arrangement, except to make each controlled participant's share of the intangible development costs equal to its share of reasonably anticipated benefits.

Section 1.482–7(b) contains the requirements for a qualified cost sharing arrangement. This provision substantially tracks the proposed regulations. A modification was made in the second requirement which now directs that the arrangement provide a method to calculate each controlled participant's share of intangible development costs, based on factors that can reasonably be expected to reflect anticipated benefits. The new standard is intended to ensure that cost sharing arrangements will not be disregarded by the IRS as long as the factors upon which an estimate of benefits was based were reasonable, even if the estimate proved to be inaccurate.

Section 1.482–7(b)(4) requires that a cost sharing arrangement be set forth in writing and contain a number of specified provisions, including the interest that each controlled participant will receive in any intangibles developed pursuant to the arrangement. The intangibles developed under a cost sharing arrangement are referred to as the ''covered intangibles.'' It is possible that the research activity undertaken may result in development of intangible property that was not foreseen at the inception of the cost sharing arrangement; any such property is also included within the definition of the term covered intangibles. The prescriptive rules in relation to the scope of the intangible development area under the proposed regulations are eliminated in favor of a flexible definition that encompasses any research and development actually undertaken under the cost sharing arrangement.

Section 1.482–7(c) provides rules for being a participant in a qualified cost sharing arrangement. Unlike the proposed regulations, the final regulations permit participation by unrelated persons, which are referred to as ''uncontrolled participants.'' Controlled taxpayers may be participants, referred to as ''controlled participants,'' if they satisfy the conditions set forth in these rules. These qualification rules replace the proposed regulations' concept of ''eligible participant.'' The tax treatment of controlled taxpayers that do not qualify as controlled participants provided in § 1.482–7(c)(4) essentially tracks the treatment provided for ineligible participants under the proposed regulations.

The requirements for being a controlled participant are basically the same as in the proposed regulations. In particular, a controlled participant must use or reasonably expect to use covered intangibles in the active conduct of a trade or business. Thus, an entity that chiefly provides services (e.g., as a contract researcher) may not be a controlled participant. These provisions are necessary for the reason that they are necessary to the proposed regulations: to prevent foreign controlled entities from being established simply to participate in cost sharing arrangements. In accordance with § 1.482–7(c)(4) mentioned above, service entities (such as contract researchers) may furnish research and development services to the members of a qualified cost sharing arrangement, with the appropriate consideration for such assistance in the research and development undertaken in the intangible development area being governed by the rules in § 1.482-4(f)(3)(iii) (Allocations with respect to assistance provided to the owner). In the case of a controlled research entity, the appropriate arm's length compensation would generally be determined under the principles of § 1.482–2(b) (Performance of services for another). Each controlled participant would be deemed to incur as part of its intangible development costs a share of such compensation equal to its share of reasonably anticipated benefits.

As under the proposed regulations, the activity of another person may be attributed to a controlled taxpayer for purposes of meeting the active conduct requirement. However, modified language is adopted to be more precise concerning the intended requirements for attribution. These requirements were phrased in the proposed regulations as bearing the risk and receiving the benefits of the attributed activity. Under the final regulations, the attribution will be made only in cases in which the controlled taxpayer exercises substantial managerial and operational control over the attributed activities.

As under the proposed regulations, a principal purpose to use cost sharing to accomplish a transfer or license of covered intangibles to uncontrolled or controlled taxpayers will defeat satisfaction of the active conduct requirement. However, a principal purpose will not be implied where there are legitimate business reasons for subsequently licensing covered intangibles.

The subgroup rules of the proposed regulations are eliminated. Their major purpose is accomplished by a simpler provision (see the discussion of § 1.482–7(h)). In addition, the final regulations treat all members of a consolidated group as a single participant.

Section 1.482–7(d) defines intangible development costs as operating expenses other than depreciation and amortization expense, plus an arm's length charge for tangible property made available to the cost sharing arrangement. Costs to be shared include all costs relating to the intangible development area, which, as noted, comprises any research actually undertaken under the cost sharing

arrangement. As under the proposed regulations, the district director may adjust the pool of costs shared in order to properly reflect costs that relate to the intangible development area.

Section 1.482–7(e) defines anticipated benefits as additional income generated or costs saved by the use of covered intangibles. The pool of benefits may also be adjusted in order to properly reflect benefits that relate to the intangible development area.

Section 1.482–7(f) governs cost allocations by the district director in order to make a controlled participant's share of costs equal to its share of reasonably anticipated benefits. Anticipated benefits of uncontrolled participants will be excluded from anticipated benefits in calculating the benefits shares of controlled participants. A share of reasonably anticipated benefits will be determined using the most reliable estimate of benefits. This rule echoes the best method rule for determining the most reliable measure of an arm's length result under § 1.482–1(c).

The reliability of an estimate of benefits principally depends on two factors: the reliability of the basis for measuring benefits used and the reliability of the projections used. The cost-to-operating-income ratio used in the proposed regulations to check the reasonableness of an effort to share costs in proportion to anticipated benefits has not been included in the final regulations. Rather, the final regulations provide that an allocation of costs or income may be made if the taxpayer did not use the most reliable estimate of benefits, which depends on the facts and circumstances of each case.

Section 1.482–7(f)(3)(ii) provides that in estimating a controlled participant's share of benefits, the most reliable basis for measuring anticipated benefits must be used, taking into account the factors set forth in § 1.482–1(c)(2)(ii). The measurement basis used must be consistent for all controlled participants. The regulations provide that benefits may be measured directly or indirectly. In addition, regardless of whether a direct or indirect basis of measurement is employed, it may be necessary to make adjustments to account for material differences in the activities that controlled participants perform in connection with exploitation of covered intangibles, such as between wholesale and retail distribution.

Section 1.482–7(f)(3)(iii) describes the scope of various indirect bases for measuring benefits, such as units, sales, and operating profit. Indirect bases other than those enumerated may be employed as long as they bear a relationship to benefits.

Section 1.482–7(f)(3)(iv) discusses projections used to estimate benefits. Projections required for this purpose generally include a determination of the time period between the inception of the research and development and the receipt of benefits, a projection of the time over which benefits will be received, and a projection of the benefits anticipated for each year in which it is anticipated that the intangible will generate benefits. However, the regulations note that in certain circumstances, current annual benefit shares may be used in lieu of projections.

Section 1.482–7(f)(3)(iv)(B) states that a significant divergence between projected and actual benefit shares may indicate that the projections were not reliable. A significant divergence is defined as divergence in excess of 20% between projected and actual benefit shares. If there is a significant divergence, which is not due to an unforeseeable event, then the district director may use actual benefits as the most reliable basis for measuring benefits. Conversely, no allocation will be made based on a divergence that is not considered significant as long as the estimate is made using the most reliable basis for measuring benefits.

For purposes of the 20% test, all non-U.S. controlled participants are treated as a single controlled participant in order that a divergence by a foreign controlled participant with a very small share of the total costs will not necessarily trigger an allocation (section 1.482–7(f)(3)(iv)(D), *Example 8*, illustrates this rule). Section 1.482–7(f)(3)(iv)(B) and (C) notes that adjustments among foreign controlled participants will only be made if the adjustment will have a substantial U.S. tax impact, for example, under subpart F.

Section 1.482–7(f)(4) states that cost allocations must be reflected for tax purposes in the year in which costs were incurred. This reflects a change from the rule in the 1992 proposed regulations, which stated that cost allocations would be included in income in the taxable year under review, even if the costs to be allocated were incurred in a prior taxable year. The purpose of the change was to match up cost adjustments with the year to which they relate in accordance with the clear reflection of income principle of section 482.

Section 1.482–7(g) provides buy-in and buy-out rules that are similar to the rules in the proposed regulations. However, some of the clarifications suggested by commenters have been incorporated in these rules. A ''substantially disproportionate'' cost-to-operating-income ratio will no longer trigger an adjustment to income under these rules. However, if, after any cost allocations authorized by § 1.482–7(a)(2), the economic substance of the arrangement is inconsistent with the terms of the arrangement over a period of years (for example, through a consistent pattern of one controlled participant bearing an inappropriately high or low share of the cost of intangible development), then the district director may impute an agreement consistent with the course of conduct. In that case, one or more of the participants would be deemed to own a greater interest in covered intangibles than provided under the arrangement, and must receive buy-in payments from the other participants.

The rules do not provide safe harbor methods for valuing intangibles, but rely on the intangible valuation rules of §§ 1.482–1 and 1.482–4 through 1.482–6. To the extent some participants furnish a disproportionately greater amount of existing intangibles to the arrangement, they must be compensated by royalties by the participants who furnish a disproportionately lesser amount of existing intangibles to the arrangement. Buy-in payments owed are netted against payments owing, and only the net payment is treated as a royalty. No implication is intended that netting of cross royalties is permissible outside of the qualified cost sharing safe harbor rules.

Section 1.482–7(h) provides rules regarding the character of payments made pursuant to a qualified cost sharing arrangement. Cost sharing payments received are generally treated as reductions of research and development expense. A net approach is applied to foster simplicity and generally preserve the character of items actually incurred by a participant to the extent not reimbursed. In addition, for purposes of the research credit determined under section 41, cost sharing payments among controlled participants will be treated as provided for intra-group transactions in § 1.41–8(e). Finally, any payment that in substance constitutes a cost sharing payment will be treated as such, regardless of its characterization under foreign law. This rule is intended to enable foreign entities to participate in cost sharing arrangements with U.S. controlled participants even if foreign law does not recognize cost sharing. This rule obviated the main reason for the subgroup rules which, as noted, have accordingly been eliminated.

Section 1.482–7(i) requires that controlled participants must use a consistent accounting method for measuring costs and benefits, and must translate foreign currencies on a consistent basis. To the extent that the accounting method materially differs from U.S. generally accepted accounting principles, any such material differences must be documented, as provided in § 1.482–7(j)(2)(iv).

Section 1.482–7(j) provides simplified recordkeeping and reporting requirements. It is anticipated that many of the background documents necessary for purposes of this section will be kept pursuant to section 6662(e) and the regulations thereunder.

Section 1.482–7(k) provides that this regulation is effective for taxable years beginning on or after January 1, 1996.

Section 1.482–7(l) allows a one-year transition period for taxpayers to conform their cost sharing arrangements with the requirements of the final regulations. A longer period was not considered necessary, given the increased flexibility and the reduced number of administrative requirements of the final regulations.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these regulations was submitted to the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of these regulations is Lisa Sams, Office of Associate Chief Counsel (International), IRS. However, other personnel from the IRS and Treasury Department participated in their development.

List of Subjects

*26 CFR Part 1*

Income taxes, Reporting and recordkeeping requirements.

*26 CFR Part 301*

Employment taxes, Estate taxes, Excise taxes, Gift taxes, Income taxes, Penalties, Reporting and recordkeeping requirements.

*26 CFR Part 602*

Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 1, 301 and 602 are amended as follows:

## PART 1—INCOME TAXES

Paragraph 1. The authority for part 1 is amended by adding an entry for section 1.482–7 to read as follows:

Authority: 26 U.S.C. 7805. * * *

Section 1.482–7 is also issued under 26 U.S.C. 482. * * *

Par. 2. Section 1.482–0 is amended by:

1. Removing the entry for § 1.482–7T.

2. Adding the entry for § 1.482–7 to read as follows:

**§ 1.482–0 Outline of regulations under 482.**

* * * * *

*§ 1.482–7 Sharing of costs.*

(a) In general.
(1) Scope and application of the rules in this section.
(2) Limitation on allocations.
(3) Cross references.
(b) Qualified cost sharing arrangement.
(c) Participant.
(1) In general.
(2) Active conduct of a trade or business.
(i) Trade or business.
(ii) Active conduct.
(iii) Examples.
(3) Use of covered intangibles in the active conduct of a trade or business.
(i) In general.
(ii) Example.
(4) Treatment of a controlled taxpayer that is not a controlled participant.
(i) In general.
(ii) Example.
(5) Treatment of consolidated group.
(d(d) Costs.
(1) Intangible development costs.
(2) Examples.
(e) Anticipated benefits.
(1) Benefits.
(2) Reasonably anticipated benefits.
(f) Cost allocations.
(1) In general.
(2) Share of intangible development costs.
(i) In general.
(ii) Example.
(3) Share of reasonably anticipated benefits.
(i) In general.
(ii) Measure of benefits.
(iii) Indirect bases for measuring anticipated benefits.
(A) Units used, produced or sold.
(B) Sales.
(C) Operating profit.
(D) Other bases for measuring anticipated benefits.
(E) Examples.
(iv) Projections used to estimate anticipated benefits.
(A) In general.
(B) Unreliable projections.
(C) Foreign-to-foreign adjustments.
(D) Examples.
(4) Timing of allocations.
(g) Allocations of income, deductions or other tax items to reflect transfers of intangibles (buy-in).
(1) In general.
(2) Pre-existing intangibles.
(3) New controlled participant.
(4) Controlled participant relinquishes interests.
(5) Conduct inconsistent with the terms of a cost sharing arrangement.
(6)Failure to assign interests under a qualified cost sharing arrangement.
(7) Form of consideration.
(i) Lump sum payments.
(ii) Installment payments.
(iii) Royalties.
(8) Examples.e
(h) Character of payments made pursuant to a qualified cost sharing arrangement.
(1) In general.
(2) Examples.
(i) Accounting requirements.
(j) Administrative requirements.
(1) In general.
(2) Documentation.
(3) Reporting requirements.
(k) Effective date.
(l) Transition rule.

* * * * *

Par. 3. Section 1.482–7 is added to read as follows:

**§ 1.482–7 Sharing of costs.**

(a) *In general*—(1) *Scope and application of the rules in this section.* A cost sharing arrangement is an agreement under which the parties agree to share the costs of development of one or more intangibles in proportion to their shares of reasonably anticipated benefits from their individual exploitation of the interests in the intangibles assigned to them under the arrangement. A taxpayer may claim that a cost sharing arrangement is a qualified cost sharing arrangement only if the agreement meets the requirements of paragraph (b) of this section. Consistent with the rules of § 1.482–1(d)(3)(ii)(B) (Identifying contractual terms), the district director may apply the rules of this section to any arrangement that in substance constitutes a cost sharing arrangement, notwithstanding a failure to comply with any requirement of this section. A qualified cost sharing arrangement, or an arrangement to which the district director applies the rules of this section, will not be treated as a partnership to which the rules of subchapter K apply. See § 301.7701–3(e) of this chapter. Furthermore, a participant that is a foreign corporation or nonresident alien individual will not be treated as engaged in trade or business within the United States solely

by reason of its participation in such an arrangement. See generally § 1.864–2(a).

(2) *Limitation on allocations.* The district director shall not make allocations with respect to a qualified cost sharing arrangement except to the extent necessary to make each controlled participant's share of the costs (as determined under paragraph (d) of this section) of intangible development under the qualified cost sharing arrangement equal to its share of reasonably anticipated benefits attributable to such development, under the rules of this section. If a controlled taxpayer acquires an interest in intangible property from another controlled taxpayer (other than in consideration for bearing a share of the costs of the intangible's development), then the district director may make appropriate allocations to reflect an arm's length consideration for the acquisition of the interest in such intangible under the rules of §§ 1.482–1 and 1.482–4 through 1.482–6. See paragraph (g) of this section. An interest in an intangible includes any commercially transferable interest, the benefits of which are susceptible of valuation. See § 1.482–4(b) for the definition of an intangible.

(3) *Cross references.* Paragraph (c) of this section defines participant. Paragraph (d) of this section defines the costs of intangible development. Paragraph (e) of this section defines the anticipated benefits of intangible development. Paragraph (f) of this section provides rules governing cost allocations. Paragraph (g) of this section provides rules governing transfers of intangibles other than in consideration for bearing a share of the costs of the intangible's development. Rules governing the character of payments made pursuant to a qualified cost sharing arrangement are provided in paragraph (h) of this section. Paragraph (i) of this section provides accounting requirements. Paragraph (j) of this section provides administrative requirements. Paragraph (k) of this section provides an effective date. Paragraph (l) provides a transition rule.

(b) *Qualified cost sharing arrangement.* A qualified cost sharing arrangement must—

(1) Include two or more participants;

(2) Provide a method to calculate each controlled participant's share of intangible development costs, based on factors that can reasonably be expected to reflect that participant's share of anticipated benefits;

(3) Provide for adjustment to the controlled participants' shares of intangible development costs to account for changes in economic conditions, the business operations and practices of the participants, and the ongoing development of intangibles under the arrangement; and

(4) Be recorded in a document that is contemporaneous with the formation (and any revision) of the cost sharing arrangement and that includes—

(i) A list of the arrangement's participants, and any other member of the controlled group that will benefit from the use of intangibles developed under the cost sharing arrangement;

(ii) The information described in paragraphs (b)(2) and (b)(3) of this section;

(iii) A description of the scope of the research and development to be undertaken, including the intangible or class of intangibles intended to be developed;

(iv) A description of each participant's interest in any covered intangibles. A covered intangible is any intangible property that is developed as a result of the research and development undertaken under the cost sharing arrangement (intangible development area);

(v) The duration of the arrangement; and

(vi) The conditions under which the arrangement may be modified or terminated and the consequences of such modification or termination, such as the interest that each participant will receive in any covered intangibles.

(c) *Participant*—(1) *In general.* For purposes of this section, a participant is a controlled taxpayer that meets the requirements of this paragraph (c)(1) (controlled participant) or an uncontrolled taxpayer that is a party to the cost sharing arrangement (uncontrolled participant). See § 1.482–1(i)(5) for the definitions of controlled and uncontrolled taxpayers. A controlled taxpayer may be a controlled participant only if it—

(i) Uses or reasonably expects to use covered intangibles in the active conduct of a trade or business, under the rules of paragraphs (c)(2) and (c)(3) of this section;

(ii) Substantially complies with the accounting requirements described in paragraph (i) of this section; and

(iii) Substantially complies with the administrative requirements described in paragraph (j) of this section.

(2) *Active conduct of a trade or business*—(i) *Trade or business.* The rules of § 1.367(a)–2T(b)(2) apply in determining whether the activities of a controlled taxpayer constitute a trade or business. For this purpose, the term *controlled taxpayer* must be substituted for the term *foreign corporation*.

(ii) *Active conduct.* In general, a controlled taxpayer actively conducts a trade or business only if it carries out substantial managerial and operational activities. For purposes only of this paragraph (c)(2), activities carried out on behalf of a controlled taxpayer by another person may be attributed to the controlled taxpayer, but only if the controlled taxpayer exercises substantial managerial and operational control over those activities.

(iii) *Examples.* The following examples illustrate this paragraph (c)(2):

*Example 1.* Foreign Parent (FP) enters into a cost sharing arrangement with its U.S. Subsidiary (USS) to develop a cheaper process for manufacturing widgets. USS is to receive the right to exploit the intangible to make widgets in North America, and FP is to receive the right to exploit the intangible to make widgets in the rest of the world. However, USS does not manufacture widgets; rather, USS acts as a distributor for FP's widgets in North America. Because USS is simply a distributor of FP's widgets, USS does not use or reasonably expect to use the manufacturing intangible in the active conduct of its trade or business, and thus USS is not a controlled participant.

*Example 2.* The facts are the same as in *Example 1*, except that USS contracts to have widgets it sells in North America made by a related manufacturer (that is not a controlled participant) using USS' cheaper manufacturing process. USS purchases all the manufacturing inputs, retains ownership of the work in process as well as the finished product, and bears the risk of loss at all times in connection with the operation. USS compensates the manufacturer for the manufacturing functions it performs and receives substantially all of the intangible value attributable to the cheaper manufacturing process. USS exercises substantial managerial and operational control over the manufacturer to ensure USS's requirements are satisfied concerning the timing, quantity, and quality of the widgets produced. USS uses the manufacturing intangible in the active conduct of its trade or business, and thus USS is a controlled participant.

(3) *Use of covered intangibles in the active conduct of a trade or business*—(i) *In general.* A covered intangible will not be considered to be used, nor will the controlled taxpayer be considered to reasonably expect to use it, in the active conduct of the controlled taxpayer's trade or business if a principal purpose for participating in the arrangement is to obtain the intangible for transfer or license to a controlled or uncontrolled taxpayer.

(ii) *Example.* The following example illustrates the absence of such a principal purpose:

*Example.* Controlled corporations A, B, and C enter into a qualified cost sharing arrangement for the purpose of developing a new technology. Costs are shared equally

among the three controlled taxpayers. A, B, and C have the exclusive rights to manufacture and sell products based on the new technology in North America, South America, and Europe, respectively. When the new technology is developed, C expects to use it to manufacture and sell products in most of Europe. However, for sound business reasons, C expects to license to an unrelated manufacturer the right to use the new technology to manufacture and sell products within a particular European country owing to its relative remoteness and small size. In these circumstances, C has not entered into the arrangement with a principal purpose of obtaining covered intangibles for transfer or license to controlled or uncontrolled taxpayers, because the purpose of licensing the technology to the unrelated manufacturer is relatively insignificant in comparison to the overall purpose of exploiting the European market.

(4) *Treatment of a controlled taxpayer that is not a controlled participant*—(i) *In general.* If a controlled taxpayer that is not a controlled participant (within the meaning of this paragraph (c)) provides assistance in relation to the research and development undertaken in the intangible development area, it must receive consideration from the controlled participants under the rules of § 1.482–4(f)(3)(iii) (Allocations with respect to assistance provided to the owner). For purposes of paragraph (d) of this section, such consideration is treated as an operating expense and each controlled participant must be treated as incurring a share of such consideration equal to its share of reasonably anticipated benefits (as defined in paragraph (f)(3) of this section).

(ii) Example. The following example illustrates this paragraph (c)(4):

*Example.* (i) U.S. Parent (USP), one foreign subsidiary (FS), and a second foreign subsidiary constituting the group's research arm (R+D) enter into a cost sharing agreement to develop manufacturing intangibles for a new product line A. USP and FS are assigned the exclusive rights to exploit the intangibles respectively in the United States and Europe, where each presently manufactures and sells various existing product lines. R+D, whose activity consists solely in carrying out research for the group, is assigned the rights to exploit the new technology in Asia, where no group member presently operates, but which is reliably projected to be a major market for product A. R+D will license the Asian rights to an unrelated third party. It is reliably projected that the shares of reasonably anticipated benefits of USP and FS (i.e., not taking R+D into account) will be 66 ⅔% and 33 ⅓%, respectively. The parties' agreement provides that USP and FS will reimburse 40% and 20%, respectively, of the intangible development costs incurred by R+D with respect to the new intangible.

(ii) R+D does not qualify as a controlled participant within the meaning of paragraph (c) of this section. Therefore, R+D is treated as a service provider for purposes of this section and must receive arm's length consideration for the assistance it is deemed to provide to USP and FS, under the rules of § 1.482–4(f)(3)(iii). Such consideration must be treated as intangible development costs incurred by USP and FS in proportion to their shares of reasonably anticipated benefits (i.e., 66 ⅔% and 33 ⅓%, respectively). R+D will not be considered to bear any share of the intangible development costs under the arrangement.

(iii) The Asian rights nominally assigned to R+D under the agreement must be treated as being held by USP and FS in accordance with their shares of the intangible development costs (i.e., 66 ⅔% and 33 ⅓%, respectively). See paragraph (g)(6) of this section. Thus, since under the cost sharing agreement the Asian rights are owned by R+D, the district director may make allocations to reflect an arm's length consideration owed by R+D to USP and FS for these rights under the rules of §§ 1.482–1 and 1.482–4 through 1.482–6.

(5) *Treatment of consolidated group.* For purposes of this section, all members of the same affiliated group (within the meaning of section 1504(a)) that join in the filing of a consolidated return for the taxable year under section 1501 shall be treated as one taxpayer.

(d) *Costs*—(1) *Intangible development costs.* For purposes of this section, a controlled participant's costs of developing intangibles for a taxable year mean all of the costs incurred by that participant related to the intangible development area, plus all of the cost sharing payments it makes to other controlled and uncontrolled participants, minus all of the cost sharing payments it receives from other controlled and uncontrolled participants. Costs incurred related to the intangible development area consist of the following items: operating expenses as defined in § 1.482–5(d)(3), other than depreciation or amortization expense, plus (to the extent not included in such operating expenses, as defined in § 1.482–5(d)(3)) the charge for the use of any tangible property made available to the qualified cost sharing arrangement. If tangible property is made available to the qualified cost sharing arrangement by a controlled participant, the determination of the appropriate charge will be governed by the rules of § 1.482–2(c) (Use of tangible property). Intangible development costs do not include the consideration for the use of any intangible property made available to the qualified cost sharing arrangement. See paragraph (g)(2) of this section. If a particular cost contributes to the intangible development area and other areas or other business activities, the cost must be allocated between the intangible development area and the other areas or business activities on a reasonable basis. In such a case, it is necessary to estimate the total benefits attributable to the cost incurred. The share of such cost allocated to the intangible development area must correspond to covered intangibles' share of the total benefits. Costs that do not contribute to the intangible development area are not taken into account.

(2) *Examples.* The following examples illustrate this paragraph (d):

*Example 1.* Foreign Parent (FP) and U.S. Subsidiary (USS) enter into a qualified cost sharing arrangement to develop a better mousetrap. USS and FP share the costs of FP's research and development facility that will be exclusively dedicated to this research, the salaries of the researchers, and reasonable overhead costs attributable to the project. They also share the cost of a conference facility that is at the disposal of the senior executive management of each company but does not contribute to the research and development activities in any measurable way. In this case, the cost of the conference facility must be excluded from the amount of intangible development costs.

*Example 2.* U.S. Parent (USP) and Foreign Subsidiary (FS) enter into a qualified cost sharing arrangement to develop a new device. USP and FS share the costs of a research and development facility, the salaries of researchers, and reasonable overhead costs attributable to the project. USP also incurs costs related to field testing of the device, but does not include them in the amount of intangible development costs of the cost sharing arrangement. The district director may determine that the field testing costs are intangible development costs that must be shared.

(e) *Anticipated benefits*—(1) *Benefits.* Benefits are additional income generated or costs saved by the use of covered intangibles.

(2) *Reasonably anticipated benefits.* For purposes of this section, a controlled participant's reasonably anticipated benefits are the aggregate benefits that it reasonably anticipates that it will derive from covered intangibles.

(f) *Cost allocations*—(1) *In general.* For purposes of determining whether a cost allocation authorized by paragraph (a)(2) of this section is appropriate for a taxable year, a controlled participant's share of intangible development costs for the taxable year under a qualified cost sharing arrangement must be compared to its share of reasonably anticipated benefits under the arrangement. A controlled participant's share of intangible development costs is determined under paragraph (f)(2) of this section. A controlled participant's share of reasonably anticipated benefits under the arrangement is determined under paragraph (f)(3) of this section. In

determining whether benefits were reasonably anticipated, it may be appropriate to compare actual benefits to anticipated benefits, as described in paragraph (f)(3)(iv) of this section.

(2) *Share of intangible development costs*—(i) *In general.* A controlled participant's share of intangible development costs for a taxable year is equal to its intangible development costs for the taxable year (as defined in paragraph (d) of this section), divided by the sum of the intangible development costs for the taxable year (as defined in paragraph (d) of this section) of all the controlled participants.

(ii) *Example.* The following example illustrates this paragraph (f)(2):

*Example.* (i) U.S. Parent (USP), Foreign Subsidiary (FS), and Unrelated Third Party (UTP) enter into a cost sharing arrangement to develop new audio technology. In the first year of the arrangement, the controlled participants incur $2,250,000 in the intangible development area, all of which is incurred directly by USP. In the first year, UTP makes a $250,000 cost sharing payment to USP, and FS makes a $800,000 cost sharing payment to USP, under the terms of the arrangement. For that year, the intangible development costs borne by USP are $1,200,000 (its $2,250,000 intangible development costs directly incurred, minus the cost sharing payments it receives of $250,000 from UTP and $800,000 from FS); the intangible development costs borne by FS are $800,000 (its cost sharing payment); and the intangible development costs borne by all of the controlled participants are $2,000,000 (the sum of the intangible development costs borne by USP and FS of $1,200,000 and $800,000, respectively). Thus, for the first year, USP's share of intangible development costs is 60% ($1,200,000 divided by $2,000,000), and FS's share of intangible development costs is 40% ($800,000 divided by $2,000,000).

(ii) For purposes of determining whether a cost allocation authorized by paragraph § 1.482–7(a)(2) is appropriate for the first year, the district director must compare USP's and FS's shares of intangible development costs for that year to their shares of reasonably anticipated benefits. See paragraph (f)(3) of this section.

(3) *Share of reasonably anticipated benefits*—(i) *In general.* A controlled participant's share of reasonably anticipated benefits under a qualified cost sharing arrangement is equal to its reasonably anticipated benefits (as defined in paragraph (e)(2) of this section), divided by the sum of the reasonably anticipated benefits (as defined in paragraph (e)(2) of this section) of all the controlled participants. The anticipated benefits of an uncontrolled participant will not be included for purposes of determining each controlled participant's share of anticipated benefits. A controlled participant's share of reasonably anticipated benefits will be determined using the most reliable estimate of reasonably anticipated benefits. In determining which of two or more available estimates is most reliable, the quality of the data and assumptions used in the analysis must be taken into account, consistent with § 1.482–1(c)(2)(ii) (Data and assumptions). Thus, the reliability of an estimate will depend largely on the completeness and accuracy of the data, the soundness of the assumptions, and the relative effects of particular deficiencies in data or assumptions on different estimates. If two estimates are equally reliable, no adjustment should be made based on differences in the results. The following factors will be particularly relevant in determining the reliability of an estimate of anticipated benefits—

(A) The reliability of the basis used for measuring benefits, as described in paragraph (f)(3)(ii) of this section; and

(B) The reliability of the projections used to estimate benefits, as described in paragraph (f)(3)(iv) of this section.

(ii) *Measure of benefits.* In order to estimate a controlled participant's share of anticipated benefits from covered intangibles, the amount of benefits that each of the controlled participants is reasonably anticipated to derive from covered intangibles must be measured on a basis that is consistent for all such participants. See paragraph (f)(3)(iii)(E), *Example 8,* of this section. Anticipated benefits are measured either on a direct basis, by reference to estimated additional income to be generated or costs to be saved by the use of covered intangibles, or on an indirect basis, by reference to certain measurements that reasonably can be assumed to be related to income generated or costs saved. Such indirect bases of measurement of anticipated benefits are described in paragraph (f)(3)(iii) of this section. A controlled participant's anticipated benefits must be measured on the most reliable basis, whether direct or indirect. In determining which of two bases of measurement of reasonably anticipated benefits is most reliable, the factors set forth in § 1.482–1(c)(2)(ii) (Data and assumptions) must be taken into account. It normally will be expected that the basis that provided the most reliable estimate for a particular year will continue to provide the most reliable estimate in subsequent years, absent a material change in the factors that affect the reliability of the estimate. Regardless of whether a direct or indirect basis of measurement is used, adjustments may be required to account for material differences in the activities that controlled participants undertake to exploit their interests in covered intangibles. See *Example 6* of paragraph (f)(3)(iii)(E) of this section.

(iii) *Indirect bases for measuring anticipated benefits.* Indirect bases for measuring anticipated benefits from participation in a qualified cost sharing arrangement include the following:

(A) *Units used, produced or sold.* Units of items used, produced or sold by each controlled participant in the business activities in which covered intangibles are exploited may be used as an indirect basis for measuring its anticipated benefits. This basis of measurement will be more reliable to the extent that each controlled participant is expected to have a similar increase in net profit or decrease in net loss attributable to the covered intangibles per unit of the item or items used, produced or sold. This circumstance is most likely to arise when the covered intangibles are exploited by the controlled participants in the use, production or sale of substantially uniform items under similar economic conditions.

(B) *Sales.* Sales by each controlled participant in the business activities in which covered intangibles are exploited may be used as an indirect basis for measuring its anticipated benefits. This basis of measurement will be more reliable to the extent that each controlled participant is expected to have a similar increase in net profit or decrease in net loss attributable to covered intangibles per dollar of sales. This circumstance is most likely to arise if the costs of exploiting covered intangibles are not substantial relative to the revenues generated, or if the principal effect of using covered intangibles is to increase the controlled participants' revenues (e.g., through a price premium on the products they sell) without affecting their costs substantially. Sales by each controlled participant are unlikely to provide a reliable basis for measuring benefits unless each controlled participant operates at the same market level (e.g., manufacturing, distribution, etc.).

(C) *Operating profit.* Operating profit of each controlled participant from the activities in which covered intangibles are exploited may be used as an indirect basis for measuring its anticipated benefits. This basis of measurement will be more reliable to the extent that such profit is largely attributable to the use of covered intangibles, or if the share of profits attributable to the use of covered intangibles is expected to be similar for each controlled participant. This circumstance is most likely to arise when covered intangibles are integral to the activity that generates the profit and

the activity could not be carried on or would generate little profit without use of those intangibles.

(D) *Other bases for measuring anticipated benefits.* Other bases for measuring anticipated benefits may, in some circumstances, be appropriate, but only to the extent that there is expected to be a reasonably identifiable relationship between the basis of measurement used and additional income generated or costs saved by the use of covered intangibles. For example, a division of costs based on employee compensation would be considered unreliable unless there were a relationship between the amount of compensation and the expected income of the controlled participants from the use of covered intangibles.

(E) *Examples.* The following examples illustrate this paragraph (f)(3)(iii):

*Example 1.* Foreign Parent (FP) and U.S. Subsidiary (USS) both produce a feedstock for the manufacture of various high-performance plastic products. Producing the feedstock requires large amounts of electricity, which accounts for a significant portion of its production cost. FP and USS enter into a cost sharing arrangement to develop a new process that will reduce the amount of electricity required to produce a unit of the feedstock. FP and USS currently both incur an electricity cost of X% of its other production costs and rates for each are expected to remain similar in the future. How much the new process, if it is successful, will reduce the amount of electricity required to produce a unit of the feedstock is uncertain, but it will be about the same amount for both companies. Therefore, the cost savings each company is expected to achieve after implementing the new process are similar relative to the total amount of the feedstock produced. Under the cost sharing arrangement FP and USS divide the costs of developing the new process based on the units of the feedstock each is anticipated to produce in the future. In this case, units produced is the most reliable basis for measuring benefits and dividing the intangible development costs because each participant is expected to have a similar decrease in costs per unit of the feedstock produced.

*Example 2.* The facts are the same as in *Example 1,* except that USS pays X% of its other production costs for electricity while FP pays 2X% of its other production costs. In this case, units produced is not the most reliable basis for measuring benefits and dividing the intangible development costs because the participants do not expect to have a similar decrease in costs per unit of the feedstock produced. The district director determines that the most reliable measure of benefit shares may be based on units of the feedstock produced if FP's units are weighted relative to USS' units by a factor of 2. This reflects the fact that FP pays twice as much as USS as a percentage of its other production costs for electricity and, therefore, FP's savings per unit of the feedstock would be twice USS's savings from any new process eventually developed.

*Example 3.* The facts are the same as in *Example 2,* except that to supply the particular needs of the U.S. market USS manufactures the feedstock with somewhat different properties than FP's feedstock. This requires USS to employ a somewhat different production process than does FP. Because of this difference, it will be more costly for USS to adopt any new process that may be developed under the cost sharing agreement. In this case, units produced is not the most reliable basis for measuring benefit shares. In order to reliably determine benefit shares, the district director offsets the reasonably anticipated costs of adopting the new process against the reasonably anticipated total savings in electricity costs.

*Example 4.* U.S. Parent (USP) and Foreign Subsidiary (FS) enter into a cost sharing arrangement to develop new anesthetic drugs. USP obtains the right to use any resulting patent in the U.S. market, and FS obtains the right to use the patent in the European market. USP and FS divide costs on the basis of anticipated operating profit from each patent under development. USP anticipates that it will receive a much higher profit than FS per unit sold because drug prices are uncontrolled in the U.S., whereas drug prices are regulated in many European countries. In this case, the controlled taxpayers' basis for measuring benefits is the most reliable.

*Example 5.* (i) Foreign Parent (FP) and U.S. Subsidiary (USS) both manufacture and sell fertilizers. They enter into a cost sharing arrangement to develop a new pellet form of a common agricultural fertilizer that is currently available only in powder form. Under the cost sharing arrangement, USS obtains the rights to produce and sell the new form of fertilizer for the U.S. market while FP obtains the rights to produce and sell the fertilizer for the rest of the world. The costs of developing the new form of fertilizer are divided on the basis of the anticipated sales of fertilizer in the participants' respective markets.

(ii) If the research and development is successful the pellet form will deliver the fertilizer more efficiently to crops and less fertilizer will be required to achieve the same effect on crop growth. The pellet form of fertilizer can be expected to sell at a price premium over the powder form of fertilizer based on the savings in the amount of fertilizer that needs to be used. If the research and development is successful, the costs of producing pellet fertilizer are expected to be approximately the same as the costs of producing powder fertilizer and the same for both FP and USS. Both FP and USS operate at approximately the same market levels, selling their fertilizers largely to independent distributors.

(iii) In this case, the controlled taxpayers' basis for measuring benefits is the most reliable.

*Example 6.* The facts are the same as in *Example 5,* except that FP distributes its fertilizers directly while USS sells to independent distributors. In this case, sales of USS and FP are not the most reliable basis for measuring benefits unless adjustments are made to account for the difference in market levels at which the sales occur.

*Example 7.* Foreign Parent (FP) and U.S. Subsidiary (USS) enter into a cost sharing arrangement to develop materials that will be used to train all new entry-level employees. FP and USS determine that the new materials will save approximately ten hours of training time per employee. Because their entry-level employees are paid on differing wage scales, FP and USS decide that they should not divide costs based on the number of entry-level employees hired by each. Rather, they divide costs based on compensation paid to the entry-level employees hired by each. In this case, the basis used for measuring benefits is the most reliable because there is a direct relationship between compensation paid to new entry-level employees and costs saved by FP and USS from the use of the new training materials.

*Example 8.* U.S. Parent (USP), Foreign Subsidiary 1 (FS1) and Foreign Subsidiary 2 (FS2) enter into a cost sharing arrangement to develop computer software that each will market and install on customers' computer systems. The participants divide costs on the basis of projected sales by USP, FS1, and FS2 of the software in their respective geographic areas. However, FS1 plans for sound business reasons not only to sell but also to license the software, and FS1's licensing income (which is a percentage of the licensees' sales) is not counted in the projected benefits. In this case, the basis used for measuring the benefits of each participant is not the most reliable because all of the benefits received by participants are not taken into account. In order to reliably determine benefit shares, FS1's projected benefits from licensing must be included in the measurement on a basis that is the same as that used to measure its own and the other participants' projected benefits from sales (e.g., all participants might measure their benefits on the basis of operating profit).

(iv) *Projections used to estimate anticipated benefits*—(A) *In general.* The reliability of an estimate of anticipated benefits also depends upon the reliability of projections used in making the estimate. Projections required for this purpose generally include a determination of the time period between the inception of the research and development and the receipt of benefits, a projection of the time over which benefits will be received, and a projection of the benefits anticipated for each year in which it is anticipated that the intangible will generate benefits. A projection of the relevant basis for measuring anticipated benefits may require a projection of the factors that underlie it. For example, a projection of operating profits may require a projection of sales, cost of sales, operating expenses, and other factors that affect operating profits. If it is anticipated that there will be significant variation among controlled participants in the timing of their receipt of benefits, and consequently

benefit shares are expected to vary significantly over the years in which benefits will be received, it may be necessary to use the present discounted value of the projected benefits to reliably determine each controlled participant's share of those benefits. If it is not anticipated that benefit shares will significantly change over time, current annual benefit shares may provide a reliable projection of anticipated benefit shares. This circumstance is most likely to occur when the cost sharing arrangement is a long-term arrangement, the arrangement covers a wide variety of intangibles, the composition of the covered intangibles is unlikely to change, the covered intangibles are unlikely to generate unusual profits, and each controlled participant's share of the market is stable.

(B) *Unreliable projections.* A significant divergence between projected benefit shares and actual benefit shares may indicate that the projections were not reliable. In such a case, the district director may use actual benefits as the most reliable measure of anticipated benefits. If benefits are projected over a period of years, and the projections for initial years of the period prove to be unreliable, this may indicate that the projections for the remaining years of the period are also unreliable and thus should be adjusted. Projections will not be considered unreliable based on a divergence between a controlled participant's projected benefit share and actual benefit share if the amount of such divergence for every controlled participant is less than or equal to 20% of the participant's projected benefit share. Further, the district director will not make an allocation based on such divergence if the difference is due to an extraordinary event, beyond the control of the participants, that could not reasonably have been anticipated at the time that costs were shared. For purposes of this paragraph, all controlled participants that are not U.S. persons will be treated as a single controlled participant. Therefore, an adjustment based on an unreliable projection will be made to the cost shares of foreign controlled participants only if there is a matching adjustment to the cost shares of controlled participants that are U.S. persons. Nothing in this paragraph (f)(3)(iv)(B) will prevent the district director from making an allocation if the taxpayer did not use the most reliable basis for measuring anticipated benefits. For example, if the taxpayer measures anticipated benefits based on units sold, and the district director determines that another basis is more reliable for measuring anticipated benefits, then the fact that actual units sold were within 20% of the projected unit sales will not preclude an allocation under this section.

(C) *Foreign-to-foreign adjustments.* Notwithstanding the limitations on adjustments provided in paragraph (f)(3)(iv)(B) of this section, adjustments to cost shares based on an unreliable projection also may be made solely among foreign controlled participants if the variation between actual and projected benefits has the effect of substantially reducing U.S. tax.

(D) *Examples.* The following examples illustrate this paragraph (f)(3)(iv):

*Example 1.* (i) Foreign Parent (FP) and U.S. Subsidiary (USS) enter into a cost sharing arrangement to develop a new car model. The participants plan to spend four years developing the new model and four years producing and selling the new model. USS and FP project total sales of $4 billion and $2 billion, respectively, over the planned four years of exploitation of the new model. Cost shares are divided for each year based on projected total sales. Therefore, USS bears 66⅔% of each year's intangible development costs and FP bears 33⅓% of such costs.

(ii) USS typically begins producing and selling new car models a year after FP begins producing and selling new car models. The district director determines that in order to reflect USS' one-year lag in introducing new car models, a more reliable projection of each participant's share of benefits would be based on a projection of all four years of sales for each participant, discounted to present value.

*Example 2.* U.S. Parent (USP) and Foreign Subsidiary (FS) enter into a cost sharing arrangement to develop new and improved household cleaning products. Both participants have sold household cleaning products for many years and have stable market shares. The products under development are unlikely to produce unusual profits for either participant. The participants divide costs on the basis of each participant's current sales of household cleaning products. In this case, the participants' future benefit shares are reliably projected by current sales of cleaning products.

*Example 3.* The facts are the same as in *Example 2*, except that FS's market share is rapidly expanding because of the business failure of a competitor in its geographic area. The district director determines that the participants' future benefit shares are not reliably projected by current sales of cleaning products and that FS's benefit projections should take into account its growth in sales.

*Example 4.* Foreign Parent (FP) and U.S. Subsidiary (USS) enter into a cost sharing arrangement to develop synthetic fertilizers and insecticides. FP and USS share costs on the basis of each participant's current sales of fertilizers and insecticides. The market shares of the participants have been stable for fertilizers, but FP's market share for insecticides has been expanding. The district director determines that the participants' projections of benefit shares are reliable with regard to fertilizers, but not reliable with regard to insecticides; a more reliable projection of benefit shares would take into account the expanding market share for insecticides.

*Example 5.* U.S. Parent (USP) and Foreign Subsidiary (FS) enter into a cost sharing arrangement to develop new food products, dividing costs on the basis of projected sales two years in the future. In year 1, USP and FS project that their sales in year 3 will be equal, and they divide costs accordingly. In year 3, the district director examines the participants' method for dividing costs. USP and FS actually accounted for 42% and 58% of total sales, respectively. The district director agrees that sales two years in the future provide a reliable basis for estimating benefit shares. Because the differences between USP's and FS's actual and projected benefit shares are less than 20% of their projected benefit shares, the projection of future benefits for year 3 is reliable.

*Example 6.* The facts are the same as in *Example 5*, except that the in year 3 USP and FS actually accounted for 35% and 65% of total sales, respectively. The divergence between USP's projected and actual benefit shares is greater than 20% of USP's projected benefit share and is not due to an extraordinary event beyond the control of the participants. The district director concludes that the projection of anticipated benefit shares was unreliable, and uses actual benefits as the basis for an adjustment to the cost shares borne by USP and FS.

*Example 7.* U.S. Parent (USP), a U.S. corporation, and its foreign subsidiary (FS) enter a cost sharing arrangement in year 1. They project that they will begin to receive benefits from covered intangibles in years 4 through 6, and that USP will receive 60% of total benefits and FS 40% of total benefits. In years 4 through 6, USP and FS actually receive 50% each of the total benefits. In evaluating the reliability of the participants' projections, the district director compares these actual benefit shares to the projected benefit shares. Although USP's actual benefit share (50%) is within 20% of its projected benefit share (60%), FS's actual benefit share (50%) is not within 20% of its projected benefit share (40%). Based on this discrepancy, the district director may conclude that the participants' projections were not reliable and may use actual benefit shares as the basis for an adjustment to the cost shares borne by USP and FS.

*Example 8.* Three controlled taxpayers, USP, FS1 and FS2 enter into a cost sharing arrangement. FS1 and FS2 are foreign. USP is a United States corporation that controls all the stock of FS1 and FS2. The participants project that they will share the total benefits of the covered intangibles in the following percentages: USP 50%; FS1 30%; and FS2 20%. Actual benefit shares are as follows: USP 45%; FS1 25%; and FS2 30%. In evaluating the reliability of the participants' projections, the district director compares these actual benefit shares to the projected benefit shares. For this purpose, FS1 and FS2 are treated as a single participant. The actual benefit share received by USP (45%) is within 20% of its projected benefit share

(50%). In addition, the non-US participants' actual benefit share (55%) is also within 20% of their projected benefit share (50%). Therefore, the district director concludes that the participants' projections of future benefits were reliable, despite the fact that FS2's actual benefit share (30%) is not within 20% of its projected benefit share (20%).

*Example 9.* The facts are the same as in *Example 8.* In addition, the district director determines that FS2 has significant operating losses and has no earnings and profits, and that FS1 is profitable and has earnings and profits. Based on all the evidence, the district director concludes that the participants arranged that FS1 would bear a larger cost share than appropriate in order to reduce FS1's earnings and profits and thereby reduce inclusions USP otherwise would be deemed to have on account of FS1 under subpart F. Pursuant to § 1.482–7 (f)(3)(iv)(C), the district director may make an adjustment solely to the cost shares borne by FS1 and FS2 because FS2's projection of future benefits was unreliable and the variation between actual and projected benefits had the effect of substantially reducing USP's U.S. income tax liability (on account of FS1 subpart F income).

*Example 10.* (i)(A) Foreign Parent (FP) and U.S. Subsidiary (USS) enter into a cost sharing arrangement in 1996 to develop a new treatment for baldness. USS's interest in any treatment developed is the right to produce and sell the treatment in the U.S. market while FP retains rights to produce and sell the treatment in the rest of the world. USS and FP measure their anticipated benefits from the cost sharing arrangement based on their respective projected future sales of the baldness treatment. The following sales projections are used:

SALES

[In millions of dollars]

| Year | USS | FP |
|---|---|---|
| 1997 | 5 | 10 |
| 1998 | 20 | 20 |
| 1999 | 30 | 30 |
| 2000 | 40 | 40 |
| 2001 | 40 | 40 |
| 2002 | 40 | 40 |
| 2003 | 40 | 40 |
| 2004 | 20 | 20 |
| 2005 | 10 | 10 |
| 2006 | 5 | 5 |

(B) In 1997, the first year of sales, USS is projected to have lower sales than FP due to lags in U.S. regulatory approval for the baldness treatment. In each subsequent year USS and FP are projected to have equal sales. Sales are projected to build over the first three years of the period, level off for several years, and then decline over the final years of the period as new and improved baldness treatments reach the market.

(ii) To account for USS's lag in sales in the first year, the present discounted value of sales over the period is used as the basis for measuring benefits. Based on the risk associated with this venture, a discount rate of 10 percent is selected. The present discounted value of projected sales is determined to be approximately $154.4 million for USS and $158.9 million for FP. On this basis USS and FP are projected to obtain approximately 49.3% and 50.7% of the benefit, respectively, and the costs of developing the baldness treatment are shared accordingly.

(iii) (A) In the year 2002 the district director examines the cost sharing arrangement. USS and FP have obtained the following sales results through the year 2001:

SALES

[In millions of dollars]

| Year | USS | FP |
|---|---|---|
| 1997 | 0 | 17 |
| 1998 | 17 | 35 |
| 1999 | 25 | 41 |
| 2000 | 38 | 41 |
| 2001 | 39 | 41 |

(B) USS's sales initially grew more slowly than projected while FP's sales grew more quickly. In each of the first three years of the period the share of total sales of at least one of the parties diverged by over 20% from its projected share of sales. However, by the year 2001 both parties' sales had leveled off at approximately their projected values. Taking into account this leveling off of sales and all the facts and circumstances, the district director determines that it is appropriate to use the original projections for the remaining years of sales. Combining the actual results through the year 2001 with the projections for subsequent years, and using a discount rate of 10%, the present discounted value of sales is approximately $141.6 million for USS and $187.3 million for FP. This result implies that USS and FP obtain approximately 43.1% and 56.9%, respectively, of the anticipated benefits from the baldness treatment. Because these benefit shares are within 20% of the benefit shares calculated based on the original sales projections, the district director determines that, based on the difference between actual and projected benefit shares, the original projections were not unreliable. No adjustment is made based on the difference between actual and projected benefit shares.

*Example 11.* (i) The facts are the same as in *Example 10,* except that the actual sales results through the year 2001 are as follows:

SALES

[In millions of dollars]

| Year | USS | FP |
|---|---|---|
| 1997 | 0 | 17 |
| 1998 | 17 | 35 |
| 1999 | 25 | 44 |
| 2000 | 34 | 54 |
| 2001 | 36 | 55 |

(ii) Based on the discrepancy between the projections and the actual results and on consideration of all the facts, the district director determines that for the remaining years the following sales projections are more reliable than the original projections:

SALES

[In millions of dollars]

| Year | USS | FP |
|---|---|---|
| 2002 | 36 | 55 |
| 2003 | 36 | 55 |
| 2004 | 18 | 28 |
| 2005 | 9 | 14 |
| 2006 | 4.5 | 7 |

(iii) Combining the actual results through the year 2001 with the projections for subsequent years, and using a discount rate of 10%, the present discounted value of sales is approximately $131.2 million for USS and $229.4 million for FP. This result implies that USS and FP obtain approximately 35.4% and 63.6%, respectively, of the anticipated benefits from the baldness treatment. These benefit shares diverge by greater than 20% from the benefit shares calculated based on the original sales projections, and the district director determines that, based on the difference between actual and projected benefit shares, the original projections were unreliable. The district director adjusts costs shares for each of the taxable years under examination to conform them to the recalculated shares of anticipated benefits.

(4) *Timing of allocations.* If the district director reallocates costs under the provisions of this paragraph (f), the allocation must be reflected for tax purposes in the year in which the costs were incurred. When a cost sharing payment is owed by one member of a qualified cost sharing arrangement to another member, the district director may make appropriate allocations to reflect an arm's length rate of interest for the time value of money, consistent with the provisions of § 1.482–2(a) (Loans or advances).

(g) *Allocations of income, deductions or other tax items to reflect transfers of intangibles (buy-in)*—(1) *In general.* A controlled participant that makes intangible property available to a qualified cost sharing arrangement will be treated as having transferred interests in such property to the other controlled participants, and such other controlled participants must make buy-in payments to it, as provided in paragraph (g)(2) of this section. If the other controlled participants fail to make such payments, the district director may make appropriate allocations, under the provisions of §§ 1.482–1 and 1.482–4 through 1.482–6, to reflect an arm's length consideration for the transferred intangible property. Further, if a group of controlled taxpayers participates in a qualified cost sharing arrangement, any change in the controlled participants' interests in covered intangibles, whether by reason of entry of a new participant or otherwise by reason of transfers (including deemed transfers) of interests among existing participants, is a transfer

of intangible property, and the district director may make appropriate allocations, under the provisions of §§ 1.482–1 and 1.482–4 through 1.482–6, to reflect an arm's length consideration for the transfer. See paragraphs (g) (3), (4), and (5) of this section. Paragraph (g)(6) of this section provides rules for assigning unassigned interests under a qualified cost sharing arrangement.

(2) *Pre-existing intangibles.* If a controlled participant makes pre-existing intangible property in which it owns an interest available to other controlled participants for purposes of research in the intangible development area under a qualified cost sharing arrangement, then each such other controlled participant must make a buy-in payment to the owner. The buy-in payment by each such other controlled participant is the arm's length charge for the use of the intangible under the rules of §§ 1.482–1 and 1.482–4 through 1.482–6, multiplied by the controlled participant's share of reasonably anticipated benefits (as defined in paragraph (f)(3) of this section). A controlled participant's payment required under this paragraph (g)(2) is deemed to be reduced to the extent of any payments owed to it under this paragraph (g)(2) from other controlled participants. Each payment received by a payee will be treated as coming pro rata out of payments made by all payors. See paragraph (g)(8), *Example 4,* of this section. Such payments will be treated as consideration for a transfer of an interest in the intangible property made available to the qualified cost sharing arrangement by the payee. Any payment to or from an uncontrolled participant in consideration for intangible property made available to the qualified cost sharing arrangement will be shared by the controlled participants in accordance with their shares of reasonably anticipated benefits (as defined in paragraph (f)(3) of this section). A controlled participant's payment required under this paragraph (g)(2) is deemed to be reduced by such a share of payments owed from an uncontrolled participant to the same extent as by any payments owed from other controlled participants under this paragraph (g)(2). See paragraph (g)(8), *Example 5,* of this section.

(3) *New controlled participant.* If a new controlled participant enters a qualified cost sharing arrangement and acquires any interest in the covered intangibles, then the new participant must pay an arm's length consideration, under the provisions of §§ 1.482–1 and 1.482–4 through 1.482–6, for such interest to each controlled participant from whom such interest was acquired.

(4) *Controlled participant relinquishes interests.* A controlled participant in a qualified cost sharing arrangement may be deemed to have acquired an interest in one or more covered intangibles if another controlled participant transfers, abandons, or otherwise relinquishes an interest under the arrangement, to the benefit of the first participant. If such a relinquishment occurs, the participant relinquishing the interest must receive an arm's length consideration, under the provisions of §§ 1.482–1 and 1.482–4 through 1.482–6, for its interest. If the controlled participant that has relinquished its interest subsequently uses that interest, then that participant must pay an arm's length consideration, under the provisions of §§ 1.482–1 and 1.482–4 through 1.482–6, to the controlled participant that acquired the interest.

(5) *Conduct inconsistent with the terms of a cost sharing arrangement.* If, after any cost allocations authorized by paragraph (a)(2) of this section, a controlled participant bears costs of intangible development that over a period of years are consistently and materially greater or lesser than its share of reasonably anticipated benefits, then the district director may conclude that the economic substance of the arrangement between the controlled participants is inconsistent with the terms of the cost sharing arrangement. In such a case, the district director may disregard such terms and impute an agreement consistent with the controlled participants' course of conduct, under which a controlled participant that bore a disproportionately greater share of costs received additional interests in covered intangibles. See § 1.482–1(d)(3)(ii)(B) (Identifying contractual terms) and § 1.482- 4(f)(3)(ii) (Identification of owner). Accordingly, that participant must receive an arm's length payment from any controlled participant whose share of the intangible development costs is less than its share of reasonably anticipated benefits over time, under the provisions of §§ 1.482–1 and 1.482–4 through 1.482–6.

(6) *Failure to assign interests under a qualified cost sharing arrangement.* If a qualified cost sharing arrangement fails to assign an interest in a covered intangible, then each controlled participant will be deemed to hold a share in such interest equal to its share of the costs of developing such intangible. For this purpose, if cost shares have varied materially over the period during which such intangible was developed, then the costs of developing the intangible must be measured by their present discounted value as of the date when the first such costs were incurred.

(7) *Form of consideration.* The consideration for an acquisition described in this paragraph (g) may take any of the following forms:

(i) *Lump sum payments.* For the treatment of lump sum payments, see § 1.482–4(f)(5) (Lump sum payments);

(ii) *Installment payments.* Installment payments spread over the period of use of the intangible by the transferee, with interest calculated in accordance with § 1.482–2(a) (Loans or advances); and

(iii) *Royalties.* Royalties or other payments contingent on the use of the intangible by the transferee.

(8) *Examples.* The following examples illustrate allocations described in this paragraph (g):

*Example 1.* In year one, four members of a controlled group enter into a cost sharing arrangement to develop a commercially feasible process for capturing energy from nuclear fusion. Based on a reliable projection of their future benefits, each cost sharing participant bears an equal share of the costs. The cost of developing intangibles for each participant with respect to the project is approximately $1 million per year. In year ten, a fifth member of the controlled group joins the cost sharing group and agrees to bear one-fifth of the future costs in exchange for part of the fourth member's territory reasonably anticipated to yield benefits amounting to one-fifth of the total benefits. The fair market value of intangible property within the arrangement at the time the fifth company joins the arrangement is $45 million. The new member must pay one-fifth of that amount (that is, $9 million total) to the fourth member from whom it acquired its interest in covered intangibles.

*Example 2.* U.S. Subsidiary (USS), Foreign Subsidiary (FS) and Foreign Parent (FP) enter into a cost sharing arrangement to develop new products within the Group X product line. USS manufactures and sells Group X products in North America, FS manufactures and sells Group X products in South America, and FP manufactures and sells Group X products in the rest of the world. USS, FS and FP project that each will manufacture and sell a third of the Group X products under development, and they share costs on the basis of projected sales of manufactured products. When the new Group X products are developed, however, USS ceases to manufacture Group X products, and FP sells its Group X products to USS for resale in the North American market. USS earns a return on its resale activity that is appropriate given its function as a distributor, but does not earn a return attributable to exploiting covered intangibles. The district director determines that USS' share of the costs (one-third) was greater than its share of reasonably anticipated benefits (zero) and that it has transferred an interest in the intangibles for which it should receive a payment from FP, whose share of the

intangible development costs (one-third) was less than its share of reasonably anticipated benefits over time (two-thirds). An allocation is made under §§ 1.482–1 and 1.482–4 through 1.482–6 from FP to USS to recognize USS' one-third interest in the intangibles. No allocation is made from FS to USS because FS did not exploit USS' interest in covered intangibles.

*Example 3.* U.S. Parent (USP), Foreign Subsidiary 1 (FS1), and Foreign Subsidiary 2 (FS2) enter into a cost sharing arrangement to develop a cure for the common cold. Costs are shared USP–50%, FS1–40% and FS2–10% on the basis of projected units of cold medicine to be produced by each. After ten years of research and development, FS1 withdraws from the arrangement, transferring its interests in the intangibles under development to USP in exchange for a lump sum payment of $10 million. The district director may review this lump sum payment, under the provisions of § 1.482–4(f)(5), to ensure that the amount is commensurate with the income attributable to the intangibles.

*Example 4.* (i) Four members A, B, C, and D of a controlled group form a cost sharing arrangement to develop the next generation technology for their business. Based on a reliable projection of their future benefits, the participants agree to bear shares of the costs incurred during the term of the agreement in the following percentages: A 40%; B 15%; C 25%; and D 20%. The arm's length charges, under the rules of §§ 1.482–1 and 1.482–4 through 1.482–6, for the use of the existing intangible property they respectively make available to the cost sharing arrangement are in the following amounts for the taxable year: A 80X; B 40X; C 30X; and D 30X. The provisional (before offsets) and final buy-in payments/receipts among A, B, C, and D are shown in the table as follows:

[All amounts stated in X's]

| | A | B | C | D |
|---|---|---|---|---|
| Payments | <40> | <21> | <37.5> | <30> |
| Receipts | 48 | 34 | 22.5 | 24 |
| Final | 8 | 13 | <15> | <6> |

(ii) The first row/first column shows A's provisional buy-in payment equal to the product of 100X (sum of 40X, 30X, and 30X) and A's share of anticipated benefits of 40%. The second row/first column shows A's provisional buy-in receipts equal to the sum of the products of 80X and B's, C's, and D's anticipated benefits shares (15%, 25%, and 20%, respectively). The other entries in the first two rows of the table are similarly computed. The last row shows the final buy-in receipts/payments after offsets. Thus, for the taxable year, A and B are treated as receiving the 8X and 13X, respectively, pro rata out of payments by C and D of 15X and 6X, respectively.

*Example 5.* A and B, two members of a controlled group form a cost sharing arrangement with an unrelated third party C to develop a new technology useable in their respective businesses. Based on a reliable projection of their future benefits, A and B agree to bear shares of 60% and 40%, respectively, of the costs incurred during the term of the agreement. A also makes available its existing technology for purposes of the research to be undertaken. The arm's length charge, under the rules of §§ 1.482–1 and 1.482–4 through 1.482–6, for the use of the existing technology is 100X for the taxable year. Under its agreement with A and B, C must make a specified cost sharing payment as well as a payment of 50X for the taxable year on account of the pre- existing intangible property made available to the cost sharing arrangement. B's provisional buy-in payment (before offsets) to A for the taxable year is 40X (the product of 100X and B's anticipated benefits share of 40%). C's payment of 50X is shared provisionally between A and B in accordance with their shares of reasonably anticipated benefits, 30X (50X times 60%) to A and 20X (50X times 40%) to B. B's final buy-in payment (after offsets) is 20X (40X less 20X). A is treated as receiving the 70X total provisional payments (40X plus 30X) pro rata out of the final payments by B and C of 20X and 50X, respectively.

(h) *Character of payments made pursuant to a qualified cost sharing arrangement*—(1) *In general.* Payments made pursuant to a qualified cost sharing arrangement (other than payments described in paragraph (g) of this section) generally will be considered costs of developing intangibles of the payor and reimbursements of the same kind of costs of developing intangibles of the payee. For purposes of this paragraph (h), a controlled participant's payment required under a qualified cost sharing arrangement is deemed to be reduced to the extent of any payments owed to it under the arrangement from other controlled or uncontrolled participants. Each payment received by a payee will be treated as coming pro rata out of payments made by all payors. Such payments will be applied pro rata against deductions for the taxable year that the payee is allowed in connection with the qualified cost sharing arrangement. Payments received in excess of such deductions will be treated as in consideration for use of the tangible property made available to the qualified cost sharing arrangement by the payee. For purposes of the research credit determined under section 41, cost sharing payments among controlled participants will be treated as provided for intra-group transactions in § 1.41–8(e). Any payment made or received by a taxpayer pursuant to an arrangement that the district director determines not to be a qualified cost sharing arrangement, or a payment made or received pursuant to paragraph (g) of this section, will be subject to the provisions of §§ 1.482–1 and 1.482–4 through 1.482–6. Any payment that in substance constitutes a cost sharing payment will be treated as such for purposes of this section, regardless of its characterization under foreign law.

(2) *Examples.* The following examples illustrate this paragraph (h):

*Example 1.* U.S. Parent (USP) and its wholly owned Foreign Subsidiary (FS) form a cost sharing arrangement to develop a miniature widget, the Small R. Based on a reliable projection of their future benefits, USP agrees to bear 40% and FS to bear 60% of the costs incurred during the term of the agreement. The principal costs in the intangible development area are operating expenses incurred by FS in Country Z of 100X annually, and operating expenses incurred by USP in the United States also of 100X annually. Of the total costs of 200X, USP's share is 80X and FS's share is 120X, so that FS must make a payment to USP of 20X. This payment will be treated as a reimbursement of 20X of USP's operating expenses in the United States. Accordingly, USP's Form 1120 will reflect an 80X deduction on account of activities performed in the United States for purposes of allocation and apportionment of the deduction to source. The Form 5471 for FS will reflect a 100X deduction on account of activities performed in Country Z, and a 20X deduction on account of activities performed in the United States.

*Example 2.* The facts are the same as in *Example 1,* except that the 100X of costs borne by USP consist of 5X of operating expenses incurred by USP in the United States and 95X of fair market value rental cost for a facility in the United States. The depreciation deduction attributable to the U.S. facility is 7X. The 20X net payment by FS to USP will first be applied in reduction pro rata of the 5X deduction for operating expenses and the 7X depreciation deduction attributable to the U.S. facility. The 8X remainder will be treated as rent for the U.S. facility.

(i) *Accounting requirements.* The accounting requirements of this paragraph are that the controlled

participants in a qualified cost sharing arrangement must use a consistent method of accounting to measure costs and benefits, and must translate foreign currencies on a consistent basis.

(j) *Administrative requirements*—(1) *In general.* The administrative requirements of this paragraph consist of the documentation requirements of paragraph (j)(2) of this section and the reporting requirements of paragraph (j)(3) of this section.

(2) *Documentation.* A controlled participant must maintain sufficient documentation to establish that the requirements of paragraphs (b)(4) and (c)(1) of this section have been met, as well as the additional documentation specified in this paragraph (j)(2), and must provide any such documentation to the Internal Revenue Service within 30 days of a request (unless an extension is granted by the district director). Documents necessary to establish the following must also be maintained—

(i) The total amount of costs incurred pursuant to the arrangement;

(ii) The costs borne by each controlled participant;

(iii) A description of the method used to determine each controlled participant's share of the intangible development costs, including the projections used to estimate benefits, and an explanation of why that method was selected;

(iv) The accounting method used to determine the costs and benefits of the intangible development (including the method used to translate foreign currencies), and, to the extent that the method materially differs from U.S. generally accepted accounting principles, an explanation of such material differences; and

(v) Prior research, if any, undertaken in the intangible development area, any tangible or intangible property made available for use in the arrangement, by each controlled participant, and any information used to establish the value of pre-existing and covered intangibles.

(3) *Reporting requirements.* A controlled participant must attach to its U.S. income tax return a statement indicating that it is a participant in a qualified cost sharing arrangement, and listing the other controlled participants in the arrangement. A controlled participant that is not required to file a U.S. income tax return must ensure that such a statement is attached to Schedule M of any Form 5471 or to any Form 5472 filed with respect to that participant.

(k) *Effective date.* This section is effective for taxable years beginning on or after January 1, 1996.

(l) *Transition rule.* A cost sharing arrangement will be considered a qualified cost sharing arrangement, within the meaning of this section, if, prior to January 1, 1996, the arrangement was a bona fide cost sharing arrangement under the provisions of § 1.482–7T (as contained in the 26 CFR part 1 edition revised as of April 1, 1995), but only if the arrangement is amended, if necessary, to conform with the provisions of this section by December 31, 1996.

**§ 1.482–7T [Removed]**

Par. 4. Section 1.482–7T is removed.

## PART 301—PROCEDURE AND ADMINISTRATION

Par. 5. The authority for part 301 continues to read in part as follows:

Authority: 26 U.S.C. 7805. * * *

Par. 6. Section 301.7701–3 is amended by adding paragraph (e) to read as follows:

**§ 301.7701–3 Partnerships.**

* * * * *

(e) *Qualified cost sharing arrangements.* A qualified cost sharing arrangement that is described in § 1.482–7 of this chapter and any arrangement that is treated by the Service as a qualified cost sharing arrangement under § 1.482–7 of this chapter is not classified as a partnership for purposes of the Internal Revenue Code. See § 1.482–7 of this chapter for the proper treatment of qualified cost sharing arrangements.

## PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 7. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 8. In § 602.101, paragraph (c) is amended by adding an entry to the table in numerical order to read as follows:

''1.482–7 .....1545–1364''.

Margaret Milner Richardson,

*Commissioner of Internal Revenue.*

Approved: November 30, 1995.

Leslie Samuels,

*Assistant Secretary of the Treasury.*

[FR Doc. 95–30617 Filed 12–19–95; 8:45 am]

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## 26 CFR Part 53

**[TD 8639]**

**RIN 1545–AT03**

## Excise Tax On Self-Dealing By Private Foundations

**AGENCY:** Internal Revenue Service (IRS), Treasury.

**ACTION:** Final regulations.

**SUMMARY:** This document contains final regulations that clarify the definition of self-dealing for private foundations. These regulations modify the application of the self-dealing rules to the provision by a private foundation of directors' and officers' liability insurance to disqualified persons. In general, these regulations provide that indemnification by a private foundation or provision of insurance for purposes of covering the liabilities of the person in his/her capacity as a manager of the private foundation is not self-dealing. Additionally, the amounts expended by the private foundation for insurance or indemnification generally are not included in the compensation of the disqualified person for purposes of determining whether the disqualified person's compensation is reasonable.

**DATES:** These regulations are effective December 20, 1995.

**FOR FURTHER INFORMATION CONTACT:** Terri Harris or Paul Accettura of the Office of the Associate Chief Counsel (Employee Benefits and Exempt Organizations), IRS, at 202–622–6070 (not a toll-free number).

**SUPPLEMENTARY INFORMATION:**

### Background

On January 3, 1995 proposed regulations amending § 53.4941(d)–2(f) [EE–56–94, 1995–6 I.R.B. 39] under section 4941 of the Internal Revenue Code of 1986 were published in the Federal Register (60 FR 82). The proposed regulations provided that generally it would not be self-dealing, nor treated as the payment of compensation, if a private foundation were to indemnify or provide insurance to a foundation manager in any civil judicial or civil administrative proceeding arising out of the manager's performance of services on behalf of the foundation. After IRS and Treasury consideration of the public comments received regarding the proposed regulations, the regulations are adopted as revised by this Treasury decision.

### Explanation of Provisions

Section 4941(a) imposes a tax on each act of self-dealing between a